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Montana Lottery

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FY 2003 Annual Report

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Letter from the Montana Lottery Director

Gerald J. LaChere, Montana Lottery Director

The primary goal of the Montana Lottery is to maximize revenues transferred to the State of Montana General Fund, while maintaining public trust in Lottery products and operations. Fiscal Year 2003 was a successful year for the Lottery, in terms of meeting its goals and objectives. We ended Fiscal Year 2003 with a transfer to the General Fund of almost $7.5 million, nearly identical to what we transferred last year.

In the first quarter of this Fiscal Year, we achieved $100 million in transfers over the lifetime of the Montana Lottery. That is a milestone, considering the Montana Lottery is the smallest Lottery in the United States.

We believe it is possible to continue transferring more than $7 million in future Fiscal Years, by operating our business with integrity, by continuing to look for product enhancements that offer players what they want to play, and by holding the line on expenses.

Our retailer network has our gratitude for their continual support as we offer new products, improve our operations, and enhance the way we conduct our business through innovation, good customer service, and secure Lottery products.

We look forward to the new product line, *Qwik Tix*, which we will introduce in Fiscal Year 2004, and believe it will meet our objectives—giving the playing public an exciting new product that has the potential to increase our sales and profit.

Sincerely,

Gerald J. LaChere

Gerald J. LaChere
Director

We achieved over $100 million in transfers in the past sixteen years.

Letter from the Montana Lottery Commissioners

L to R Standing: Commissioners Cliff Brophy, Columbus; Don Sternhan, Billings; Tom Keegan, Helena.
L to R Seated: Commissioner Betty Wilkins, Missoula; Chairman Bob Crippen, Butte.

The Montana Lottery is a business we're proud to assist with our expertise. Our Director and his capable staff continue to innovatively offer new products, while holding the line on expenses and maximizing the transfer to the State of Montana General Fund.

In Fiscal Year 2003, the Lottery was able to once again exceed its transfer goal, and, for the second year in a row, transfer nearly $7.5 million. We think that is an accomplishment worth noting, especially since we are over $1 million more in transfers when compared to the average transfer for Fiscal Years 1997 through 2001. We believe we have achieved a new base level of transfers of more than $7 million to the General Fund, a level we plan to continue. These successes were accomplished through adopting changes to the Powerball game, introducing a new $3 Scratch game, Slingo, and increasing our Lotto retailer network.

Another commendable effort on the part of the Lottery is holding the line on operating expenses at approximately $3 million over the past four years. This expense history has held through four consecutive years of increasing sales. We again salute the efforts of the Lottery Director and his staff.

We will continue to assist the Montana Lottery Director and staff in the goal of maximizing revenue for important state programs, while protecting the security and integrity of Lottery games in Montana.

•Transfers to the General Fund have surpassed $7,000,000 this Fiscal Year!

Montana Lottery Products

The Montana Lottery currently sells a variety of Scratch games and four Lotto games, Powerball, Montana Cash, Wild Card and Hot Lotto. Profits from sales of these games are transferred on a quarterly basis to the State's General Fund.

Scratch games are played by scratching the latex covering off the play area of the ticket. If the player uncovers an established number of like symbols or dollar amounts, the ticket is a winner. Montana Lottery's Scratch sales strategy is to offer multiple games simultaneously with a variety of play styles, graphics and themes to provide increased appeal to a wide variety of players. Scratch games have been sold by the Lottery since 1987, and continue to be strong sellers. In Fiscal Year 2003, the Montana Lottery introduced 33 different Scratch games, with top prizes ranging from $50 to $50,000. Overall odds of winning a prize in Scratch games are around one in four. Prize expense in Fiscal Year 2003 totaled $5.9 million or 58% of sales.

Montana Cash was custom designed with extensive feedback from Montanans, and was introduced in May of 1991. The jackpot is a growing cash jackpot starting at a guaranteed minimum $20,000. The odds of winning the jackpot are 1 in 217,949. Overall odds of winning are one in 43. In Fiscal Year 2003, seventeen players won jackpots ranging from $30,000 to $220,000. Prize expense totaled almost $2 million, or 50% of sales.

Powerball is played with 25 other lotteries. The cooperative effort offers small states like Montana the advantage of multi-million dollar jackpots, combined with lower operating costs. The jackpot starts at a guaranteed $10 million and grows from there if no one matches the winning numbers. The jackpot is a 30-payment annuity with a cash option. The odds of winning the jackpot are 1 in 121 million, but overall odds of winning a prize are 1 in 36.

The top Powerball prize in Montana in Fiscal Year 2003 was $100,000, won by five Montana players. Another 32 players won $5,000. Total prize expense was approximately $7.3 million, or 46% of sales.

Wild Card is a Lotto game played with Idaho and South Dakota. The growing cash jackpot begins at $100,000. Jackpot odds are 1 in 1.4 million, while overall odds are 1 in 6. In Fiscal Year 2003, three Montana players won jackpots ranging from $135,000 to $279,000. Prize expense totaled $1.2 million, or 52% of sales.

Hot Lotto, the newest Lotto game in Montana, began April 2002. It is played in five states in addition to Montana. It is a Powerball-type game, with a minimum annuitized jackpot of $1 million. Jackpot odds are approximately 1 in 10.9 million, and overall odds of winning are approximately 1 in 16.

In Fiscal Year 2003, three Montana players won the second-tier prize, $10,000. Total prize expense for the year was $1.1 million, or 51% of sales.

Lottery Operations and Profits

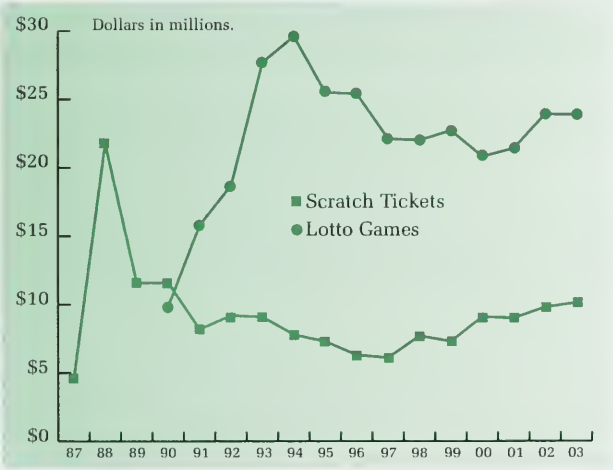
The Montana Lottery is a self-supporting government business that generates a profit for the State of Montana. Lottery operations are entirely funded through the sale of Scratch and Lotto tickets. No tax dollars go to support the Lottery.

Revenue generated through the sale of Lottery tickets is used to fund pries, pay retailer commissions and cover ticket costs and operating expenses. Net revenue is transferred on a quarterly basis to the General Fund of the State of Montana. Section 23-7-402, MCA, specifies how each dollar spent on Lottery tickets is to be distributed. Below is an overview of sales and expenditures for the past four years.

Dollars in millions.	FY 00	FY 01	FY 02	FY 03
Revenue	$30.2	$30.7	$33.8	**$34.7**
Prizes	15.6	15.7	17.1	**17.5**
Commissions	1.7	1.7	2.0	**2.0**
Ticket Costs	4.1	4.2	4.4	**4.8**
Operations	3.0	3.0	3.0	**2.9**
Change in Accounting Principle			.2	
Proceeds to State of Montana General Fund	**$ 5.8**	**$ 6.1**	**$ 7.5**	**$ 7.5**

Explanation of Categories:

Revenue: Ticket sales, earnings on investments, licensing fees, and other miscellaneous income. Montana Lottery ticket sales from Fiscal Year 1987 through Fiscal Year 2003 total over $466 million. Income other than ticket sales for the Lottery's entire history totals approximately $2.9 million.

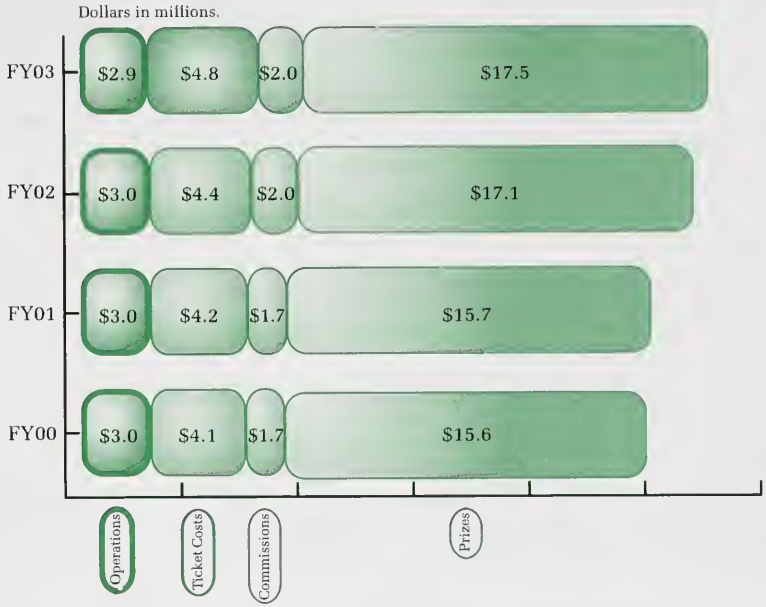


Prizes: A minimum of 45 percent of all sales revenue is returned to players in the form of prizes. Through the end of Fiscal Year 2003, over $230 million has been paid to players in the form of prizes.

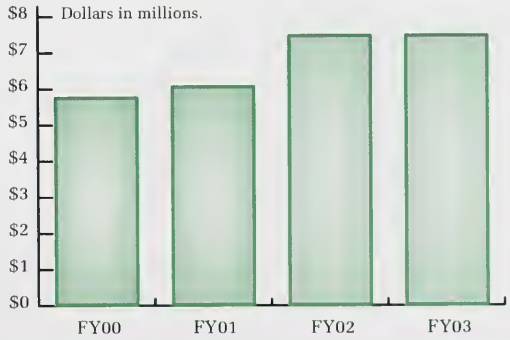
Commissions: Lottery retailers earn a five percent base commission on each ticket sold. They also have an opportunity to earn additional commissions through a Scratch ticket retailer incentive program. Every Scratch ticket sold over an established base qualifies retailers for an incremental bonus of 0.5 to 5 percent. Total retailer commissions through the end of Fiscal Year 2003 total over $26 million.

Ticket Costs: Include printing of Scratch tickets, the fee per ticket sold (Lotto and Scratch) paid to the Lottery's gaming system vendor, and expenses related to the Lottery's gaming system. In March 1999, the Lottery entered into an agreement with Autotote Lottery Corporation (now Scientific Games, International) to purchase software, hardware and related services to allow sales of Lotto tickets and Scratch ticket validation and accounting. Ticket costs starting with FY 1998 include depreciation, amortization and interest expense.

Operations: Operating expenses include personnel expenses, advertising, supplies and materials, rent and utilities, and repairs and maintenance. Over the past four years, operating expense have remained under 10 percent of total revenue.



Proceeds to State of Montana General Fund: Beginning July 1, 1995, Lottery net revenue is transferred on a quarterly basis to the State of Montana General Fund. The General Fund provides money to state programs which do not have a dedicated revenue source. This change was enacted in the 1995 Legislative Session. In Fiscal Year 2003, the General Fund received nearly $7.5 million. Through Fiscal Year 2003, the Lottery has transferred over $54 million to the General Fund. Total transfers since 1987 are over $106 million through the end of Fiscal Year 2003.



Looking Ahead

Qwik Tix™

Qwik Tix will be introduced on February 2 at Montana Lottery locations across the state. Qwik Tix will be a brand new type of game for Montana.

What's new about Qwik Tix?

The Lotto terminal will print Qwik Tix at the time of purchase. They're not Scratch tickets, and they're not Lotto, either. Like Scratch tickets, they can be played and winners cashed immediately. Like Lotto tickets, they will be printed by the Lotto terminal. No other lottery has developed and presented instant win games in the same manner as the Montana Lottery has developed Qwik Tix.

Four new games, and eight new ways to play, will be introduced with this new product line. The four games are:

These games will sell for $2, either two plays of the individual Qwik Tix game, or one play in combination with its partner Lotto game: Lucky Numbers with Powerball; Hot-Tac-Toe with Hot Lotto; Jacks or Better with Wild Card; and Montana Match with Montana Cash.

The Montana Lottery designed these games specifically for Montana Lottery players. All Lottery staff, our lottery gaming system vendor, Scientific Games, our advertising agency, Banik Communications, our scratch ticket vendor, Oberthur Gaming Technologies, Inc., and our research vendor, Ipsos Reid, have also been instrumental in developing this product group.

It truly is a brand new way to play the Montana Lottery!

•A brand new way to play! Four new games and eight ways to play!

Independent Auditors' Report

To the Commissioners
Montana State Lottery
Helena, Montana

We have audited the accompanying financial statements of the Montana State Lottery (the Lottery), an enterprise fund of the State of Montana, as of and for the years ended June 30, 2003 and 2002. These financial statements are the responsibility of the Lottery's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note A, the financial statements present only the Lottery and are not intended to present the financial position of the State of Montana and the results of its operations and cash flows of its proprietary fund types in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Lottery, an enterprise fund of the State of Montana, as of June 30, 2003 and 2002, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued a report dated October 8, 2003 on our consideration of the Lottery's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

The Management's Discussion and Analysis on pages 8 through 10 are not a required part of the basic financial statements but are supplementary information recommended by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

Galusha, Higgins & Galusha, PC

GALUSHA, HIGGINS AND GALUSHA, PC
Certified Public Accountants and Advisors

Helena, Montana
October 8, 2003

Management's Discussion and Analysis

The following *Management Discussion and Analysis* (MD&A) of the Montana State Lottery's (the Lottery) activities and financial performance provides the reader with an introduction to and overview of the financial statements for the Fiscal Years ended June 30, 2003 and 2002. This discussion is an element of the new reporting model adopted by the Government Accounting Standards Bureau (GASB) Statement No. 34 in Fiscal Year 2002. We encourage readers to consider this information in conjunction with the financial statements, which directly follow.

REQUIRED FINANCIAL STATEMENTS

The Lottery is classified as a special-purpose government fund engaged only in business-type activities. Accordingly, the Lottery operates in much the same manner as commercial enterprises using the full accrual method of accounting. The basic financial statements consist of two components:

1) Three Fund Financial Statements: a *Statement of Net Assets*, a *Statement of Revenues, Expenses, and Changes in Fund Net Assets*, and a *Statement of Cash Flows*; and

2) Notes to the Financial Statements.

The *Statement of Net Assets* includes both short-term and long-term assets and liabilities. Long-term fixed assets are capitalized and depreciated over their useful lives. Because the Lottery is required to transfer all "profits," or the excess of assets over liabilities, to the State's General Fund, its "net assets" will always be zero.

The *Statement of Revenues, Expenses, and Changes in Fund Net Assets*, includes all of the current year's revenues and expenses. Revenues are recognized when earned and become measurable, not when they are received. Expenses are recognized when incurred, not when paid. This statement measures the success of the Lottery's operations over the past year and details the total amount transferred to the General Fund.

The final statement is the *Statement of Cash Flows*. The primary purpose is to provide information about the cash receipts and payments, and changes in cash resulting from operations, investing and financial activities.

NET ASSETS

The table below presents a summary of the Lottery's *Statement of Net Assets*.

Condensed Statements of Net Assets as of June 30, 2003 and 2002

	FY 2003	FY 2002	Change
Current Assets	$2,132,236	$2,015,564	$116,672
Capital Assets (Net of Depreciation)	2,954,696	3,977,175	(1,022,479)
Other Assets	1,742,643	2,100,876	(358,233)
Total Assets	**$6,829,575**	**$8,093,615**	**$(1,264,040)**
Current Liabilities	$5,052,373	$5,209,339	$(156,966)
Long-Term Liabilities	1,777,202	2,884,276	(1,107,074)
Total Liabilities	**$6,829,575**	**$8,093,615**	**$(1,264,040)**
Invested in Capital Assets, Net of Related Debt	$1,844,860	$1,812,553	$ 32,307
Unrestricted Net Assets	(1,844,860)	(1,812,553)	(32,307)
TOTAL NET ASSETS	**$ 0**	**$ 0**	**$ 0**

Most of the change in Capital Assets is due to depreciation on the Games Management System and amortization of the software associated with that system. The decrease in Other Assets is a reduction in the unreserved account held with the Multi-State Lottery Association. The account is comprised of interest earned and reserves held for prize payments.

The major change in liabilities is the result of payments made on the Lottery's long-term loan. Additional information on this debt is contained in the debt analysis section.

The category, *Invested in Capital Assets, Net of Related Debt*, consists of capital assets less accumulated depreciation, amortization and the outstanding balance on the debt related to the purchase of these assets.

OPERATIONS AND CHANGES IN NET ASSETS

The table below presents a summary of the Lottery's Operations for the last two years:

Condensed Statements of Revenues, Expenses & Changes in Fund Net Assets
For the Years Ended June 30, 2003 and 2002

	FY 2003	FY 2002	Favorable (Unfavorable) Variance
Operating Revenues	$34,696,380	$33,670,324	$1,026,056
Ticket Expenses	(23,257,373)	(22,560,072)	(697,301)
Net Operating Revenue	**$11,439,007**	**$11,110,252**	**$ 328,755**
Operating Expenses	(3,981,365)	(3,890,552)	(90,813)
Net Operating Income	**$ 7,457,642**	**$ 7,219,700**	**$ 237,942**
Non-Operating Income/(Expenses)	(4,361)	9,647	(14,008)
Income before Operating Transfer	**$ 7,453,281**	**$ 7,229,347**	**$ 223,934**
Change in Accounting Principle		237,683	(237,683)
Transfer to General Fund	$ (7,453,281)	$ (7,467,030)	$ 13,749
Change in Net Assets	**$ 0**	**$ 0**	**$ 0**

Strong sales of Scratch tickets, Powerball and Hot Lotto resulted in an overall increase of 3.05% for operating revenue over Fiscal Year 2002. Ticket expenses, which are directly related to sales, had a similar increase. Prize costs are one element of ticket expense and this was reduced by $333,627 for the Lottery's portion of an unclaimed Powerball jackpot.

Total operating expenses remained steady. Some individual expense categories with differences of note were: Depreciation and Amortization increased by $183,291 because of equipment purchases in Fiscal Year 2002, Personal Services increased by $121,498 because of a legislative pay increase and no vacant positions, and Supplies and Materials decreased by $175,944 because promotional items were not purchased due to budget decreases instituted in the legislative Special Session.

The income from non-operating activities was less than the previous year. This category includes interest received from investments and interest paid on the long-term loan. The reduction was the result of lower return on investments.

The increase in sales, ticket expense abatement and steady operating expenses resulted in the Lottery transferring more that $7 million to the General Fund for the second straight year; the last time the Lottery transferred $7 million was in 1996.

CAPITAL ASSETS AND DEBT ADMINISTRATION

The Lottery follows the State's policy of capitalizing fixed assets with an historical value of $5,000 or more. The Lottery holds two main types of fixed assets: 1) a fleet of vehicles used by the sales staff and 2) the Games Management System (GMS), which tracks and controls the sale of all Lottery products, validation of winning tickets, and payments to winners. GMS consists of centralized computer equipment and operating software located in Helena and includes all of the terminals, both for scratch and lotto games, located at retail locations.

Fixed assets are depreciated using the straight-line method over the appropriate estimated useful life, ranging from three to seven years.

In Fiscal Year 2003, fixed asset purchases consisted of two replacement vehicles for $39,396.

In 1999, the Lottery entered into a loan agreement with Norwest Investment Services to purchase the Games Management System. The 5-year loan was for $5,025,311 at 5.12% interest and payments are made quarterly. At the end of Fiscal Year 2003, the outstanding principal amount is $1,109,836, a reduction of $1,054,786 from the previous year. This loan will be completely paid during Fiscal Year 2004.

The Lottery has no other debt-related commitments.

LOOKING AHEAD

The Lottery's goal is to maximize revenue for the State's programs while maintaining the public trust in lottery gaming. This requires offering games that Lottery players want to play, providing convenient locations for the purchase, and controlling operating expenses.

The Lottery introduces new scratch games on a regular basis. In Fiscal Year 2003, 33 games featuring different graphics, play styles, and prize levels were introduced. Approximately the same number of newly introduced games will be presented in Fiscal Year 2004.

In the third quarter of Fiscal Year 2004, the Lottery plans to launch a new product line that combines features from both the current lotto games and the instant scratch game offerings. These new products will provide the opportunity to win an immediate prize on tickets produced and printed on the lotto terminals. The Lottery conducted marketing research which demonstrated player interest in the games.

The Lottery will also continue its efforts to increase the number of retail outlets throughout the state with new terminal placements or by upgrading current scratch-only retailers to full service locations.

Exceptional increases in lotto revenue are usually the result of higher jackpots; however, such jackpots cannot be predicted nor depended upon to occur at any specific time. Therefore, omitting the possibility of a record jackpot, the Lottery projects that the transfer to the General Fund in Fiscal Year 2004 will be approximately $7 million.

CONTACTING THE LOTTERY'S FINANCIAL MANAGEMENT

This financial report is designed to provide a general overview of the Lottery's finances for all of Montana's citizens, taxpayers, players, investors and creditors, and to report on the Lottery's accountability for its funds. Questions concerning any of the information provided in this report or requests for additional information should be addressed to:

Montana Lottery, 2525 N. Montana Avenue, Helena, MT 59604.

Statements of Net Assets

	As of June 30, 2003	2002
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	**244,733**	391,199
Accounts receivable, net of allowance	**1,248,688**	796,271
Due from other funds	**584**	2,645
Inventory	**607,261**	812,944
Other current assets	**30,970**	19,087
Total current assets	**2,132,236**	2,022,146
FURNITURE AND EQUIPMENT		
Furniture and equipment	**5,589,216**	5,562,699
Accumulated depreciation	**(3,086,306)**	(2,208,177)
Total furniture and equipment	**2,502,910**	3,354,522
INTANGIBLE ASSETS		
Software, net of accumulated amortization	**451,786**	616,071
OTHER ASSETS		
MUSL Prize Reserve fund	**1,742,643**	2,100,876
TOTAL ASSETS	**6,829,575**	8,093,615
LIABILITIES AND NET ASSETS		
CURRENT LIABILITIES		
Accounts payable	**465,039**	1,015,848
Accrued interest payable	**10,260**	20,011
Estimated prize liability	**1,340,477**	1,336,547
Transfer obligations to general fund	**1,811,272**	1,591,454
Due to other state agencies	**35,013**	10,448
Deferred on-line revenue	**173,133**	78,821
Current portion of accrued compensated absences	**107,343**	101,424
Current portion of note payable	**1,109,836**	1,054,786
Total current liabilities	**5,052,373**	5,209,339
LONG-TERM LIABILITIES		
MUSL prize liability	**1,699,207**	1,707,049
Long-term portion of note payable	**-**	1,109,836
Long-term portion of accrued compensated absences	**77,995**	67,391
Total long-term liabilities	**1,777,202**	2,884,276
TOTAL LIABILITIES	**6,829,575**	8,093,615
COMMITMENTS AND CONTINGENCIES		
NET ASSETS		
Invested in capital assets, net of related debt	**1,844,860**	1,812,553
Unrestricted net assets	**(1,844,860)**	(1,812,553)
TOTAL NET ASSETS	**-**	-
TOTAL LIABILITIES AND NET ASSETS	**6,829,575**	8,093,615

The accompanying notes are an integral part of these financial statements.

Statements of Revenues, Expenses, and Changes In Fund Net Assets

	For the years ended June 30, 2003	2002
OPERATING REVENUES		
Scratch ticket games	**10,134,734**	9,774,100
On-line games	**24,547,760**	23,858,173
Miscellaneous	**13,886**	38,051
Total operating revenues	**34,696,380**	33,670,324
DIRECT GAME COSTS		
Scratch ticket prize expense	**5,918,176**	5,643,263
On-line ticket prize expense	**11,644,782**	11,460,703
Retailer commission	**2,035,751**	1,982,254
On-line vendor fees	**2,899,115**	2,808,117
Cost of tickets sold	**759,549**	665,735
Total direct game costs	**23,257,373**	22,560,072
Income before operating expenses	**11,439,007**	11,110,252
OPERATING EXPENSES		
Advertising	**555,402**	566,253
Communications	**83,602**	99,067
Advertising production	**158,736**	183,510
Audit fees	**58,264**	27,793
Contractual services	**145,505**	149,839
Depreciation and amortization	**1,053,362**	870,071
Management fees	**70,888**	70,888
Multi-state operating fees	**89,435**	76,426
Other	**36,450**	37,071
Personal services	**1,382,005**	1,260,507
Public relations	**25,784**	61,849
Repairs and maintenance	**27,324**	22,226
Supplies and materials	**160,915**	336,859
Utilities and rent	**106,443**	99,775
Travel	**27,250**	28,418
Total operating expenses	**3,981,365**	3,890,552
OPERATING NET INCOME	**7,457,642**	7,219,700
NON-OPERATING REVENUES (EXPENSES)		
Interest income	**77,140**	145,599
Interest expense	**(81,041)**	(133,844)
Security lending income	**-**	825
Security lending costs	**-**	(739)
Loss on disposal of furniture and equipment	**(460)**	(2,194)
Total non-operating net income	**(4,361)**	9,647
INCOME BEFORE OPERATING TRANSFERS	**7,453,281**	7,229,347
OPERATING TRANSFERS OUT		
General fund	**7,453,281**	7,467,030
Total operating transfers out	**7,453,281**	7,467,030
Change in net assets due to cumulative change in accounting principle	**-**	(237,683)
Net assets, beginning of year	**-**	237,683
Net assets, end of year	**-**	-

The accompanying notes are an integral part of these financial statements.

Statements of Cash Flows

	For the years ended June 30, 2003	2002
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash received from sales	**34,340,379**	33,800,214
Cash paid to suppliers for goods and services	**(6,790,847)**	(7,071,674)
Cash paid to employees	**(1,299,099)**	(1,315,780)
Cash paid for prizes	**(17,233,442)**	(17,305,122)
Net cash provided by operating activities	**9,016,991**	8,107,638
CASH FLOWS FROM NON-CAPITAL FINANCING ACTIVITIES		
Operating transfers out:		
General fund	**(7,233,463)**	(7,784,243)
Net cash used by non-capital financing activities	**(7,233,463)**	(7,784,243)
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Purchase of fixed assets	**(798,396)**	(48,735)
Interest paid	**(90,792)**	(143,111)
Payments on long-term borrowing	**(1,054,786)**	(1,002,466)
Proceeds from sale of fixed assets	**1,472**	-
Net cash used by capital and related financing activities	**(1,942,502)**	(1,194,312)
CASH FLOWS FROM INVESTING ACTIVITIES		
Interest and dividend income	**12,508**	45,794
Security lending income	**-**	825
Security lending costs	**-**	(739)
Net cash provided by investing activities	**12,508**	45,880
NET DECREASE IN CASH AND CASH EQUIVALENTS	**(146,466)**	(825,037)
Cash and cash equivalents, beginning of year	**391,199**	1,216,236
Cash and cash equivalents, end of year	**244,733**	391,199
RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES		
Operating income	**7,457,642**	7,219,700
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation and amortization	**1,053,362**	870,071
Changes in net assets and liabilities:		
(Increase) decrease in accounts receivable	**(452,417)**	102,030
(Increase) decrease in due from other state agencies	**2,061**	(690)
Decrease in inventory	**205,683**	338,803
Increase in other current assets	**(11,883)**	(896)
Decrease in long-term receivable	**358,233**	164,620
Interest receivable included in long-term receivable	**64,631**	106,989
Decrease in other intangible assets	**-**	(1,642)
Increase (decrease) in accounts payable	**208,191**	(239,350)
Decrease in lottery prizes payable	**(3,912)**	(389,155)
Increase in deferred revenue	**94,312**	19,657
Increase (decrease) in due to other state agencies	**24,565**	(78,037)
Increase (decrease) in compensated absences payable	**16,523**	(4,462)
Net cash provided by operating activities	**9,016,991**	8,107,638

The accompanying notes are an integral part of these financial statements.

Notes to the Financial Statements

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization - The Montana State Lottery (hereafter referred to as the Lottery) was created in November 1986 by a referendum vote of the people of Montana.

Section 23-7-101, Montana Code Annotated (MCA) establishes the provision of the code under which the Lottery operates. The Lottery is operated by a five-member commission consisting of Montana residents appointed by the Governor. The Commission, by law, has the power to operate a state lottery, determine the type and forms of lottery games, set ticket prices, determine the number and size of prizes, conduct lottery drawings, enter into agreements to offer lottery games with other states, and prepare financial reports. The Lottery is attached to the Department of Administration for administrative purposes.

Disposition of revenue is a minimum of 45 percent for prizes and a maximum of 10 percent for commission to sales agents. The remaining revenue, less expenses, is transferred to the Montana State General Fund.

Reporting Entity - The Lottery is included in the State of Montana's financial statements as an enterprise fund. In accordance with governmental accounting and financial reporting standards, there are no component units to be included within the Lottery's financial statements as a reporting agency.

Basis of Accounting - The Lottery utilizes the accrual basis of accounting and is classified as an enterprise fund of the governmental proprietary fund type. Enterprise funds account for operations similar to private business enterprises where the intent of the Legislature is that costs are to be financed or recovered primarily through user charges, or where the Legislature has decided that periodic determination of revenue earned, expenses incurred or net income is appropriate.

Revenue Recognition - Sales of scratch lottery tickets are made to licensed retailers who market the tickets to the public on a commission basis. Revenue is recognized when tickets are activated by retailers. Tickets activated, but not sold by retailers, may be returned for credit. Sales are reduced for estimated ticket returns.

Sales of on-line lottery tickets are made to licensed retailers who market the tickets through the use of computerized terminals on a commission basis. Revenue is recognized on drawing dates. Tickets sold in advance of future drawing dates are recorded as deferred revenue until the ticket becomes valid for a drawing.

Cash and Cash Equivalents - Cash and cash equivalents consist of interest-bearing deposits with the Montana Board of Investments short-term investments pool, cash deposited with banks and cash on deposit with the Montana State Treasurer that is part of the State's pooled cash and is not separately identifiable as to specific types of securities. These funds are highly liquid and may be drawn on daily.

Allowance for Uncollectible Accounts - The Lottery uses the allowance method to account for uncollectible receivables. The allowance is based on management's estimate of possible bad debts.

Advertising Costs - Advertising costs are expensed as incurred.

Allowance for Returned Tickets - The Lottery's policy is to accept any unplayed scratch ticket from a retailer for credit without regard to when the ticket or pack of tickets was activated. Therefore, an allowance to recognize the possibility of returns is calculated at the end of each Fiscal Year.

Inventory - Inventory consists of tickets and supplies. Ticket inventory includes scratch lottery tickets that are carried at cost using the specific identification method. Tickets are charged to cost of sales when activated. Unsold tickets are charged to cost of sales upon the end or cancellation of the related game. Supply inventory is carried at cost and expensed as used.

Prizes - Prize expense is recognized based on a predetermined prize structure for each scratch ticket and on-line game. Free tickets are recorded as a reduction in revenue and not as prize expense.

Unclaimed Prizes - Prizes for the online games, Powerball, Wild Card, Rolldown (discontinued in April 2002), Hot Lotto, and Montana Cash, must be claimed within six months after the appropriate draw date. Prizes for scratch games must be claimed within six months of the announced end of each game. The unclaimed prize amounts are taken as a reduction in the Lottery Prizes Payable liability and the Prize Expense and are transferred to the State of Montana General Fund as a portion of the quarterly transfer. The combined amounts of unclaimed prizes for online games were $957,718 and $778,922 and for the scratch games were $345,029 and $348,195 for the Fiscal Years ended June 30, 2003 and 2002, respectively.

Intangible Assets - Intangible assets consist of software and represents the unamortized cost of software purchased in 1999. This software had an original cost of $1,150,000 and is being amortized over seven years.

Furniture and Equipment - Furniture and equipment are recorded at cost. Donated furniture and equipment are recorded at their estimated fair market value at the date of donation. Ordinary maintenance and repairs are charged to operations as incurred; major renewals and betterments are capitalized. Upon disposition or retirement of furniture and equipment, the cost and related accumulated depreciation or amortization are removed from the accounts. Gain or loss on disposal is reflected in nonoperating revenues and expenses. Depreciation and amortization are calculated on a straight-line basis over estimated useful lives of three to seven years. The Lottery conforms to the State of Montana capitalization threshold for recording furniture and equipment. This threshold is $5,000.

Compensated Absences - State employees earn vacation leave ranging from fifteen to twenty-four days per year based on years of service. Vacation leave may be accumulated to a total not to exceed twice the maximum number of days earned annually. Sick leave accumulates at a rate of twelve days per year with no maximum accumulation. Upon retirement or termination, an employee is paid for 100 percent of unused vacation leave and 25 percent of unused sick leave.

Use of Estimates - The preparation of financial statements in conformity with Generally Accepted Accounting Principles (GAAP) requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates.

NOTE B - CASH AND CASH EQUIVALENTS

Cash and cash equivalents consist of the following:

	June 30, 2003	June 30, 2002
Short-term investment pool	$ -	$185,445
Cash on deposit with State T reasurer	234,583	195,604
Cash in revolving deposit account	10,000	10,000
Petty Cash	150	150
	$244,733	$391,199

The Lottery participates in the Montana Board of Investments Short Term Investment Pool (STIP). STIP balances are highly liquid investments with maturities of 397 days or less. There are no legal risks that the Board of Investments is aware of regarding any STIP investments. The bank balance of the revolving deposit account was $149,744 and $19,568 at June 30, 2003 and 2002, respectively, and was covered by federal depository insurance up to $100,000. The carrying amount reported in the Statement of Net Assets for cash and cash equivalents approximates the fair market value.

NOTE C - ACCOUNTS RECEIVABLE

Accounts receivable consists of the following:

	June 30, 2003	June 30, 2002
Accounts receivable	$1,449,930	$992,715
Allowance for returned tickets	(201,242)	(196,444)
	$1,248,688	$796,271

NOTE D - INVENTORY

Inventory consists of the following:

	June 30, 2003	June 30, 2002
Scratch tickets	$538,571	$699,250
Supplies	68,690	113,694
	$607,261	$812,944

NOTE E - OTHER CURRENT ASSETS

Other current assets consist of the following:

	June 30, 2003	June 30, 2002
Prepaid expenses	$26,170	$14,057
Employee travel advances	4,800	5,030
	$30,970	$19,087

NOTE F - FURNITURE AND EQUIPMENT

A summary of furniture and equipment for the Montana Lottery is as follows:

	June 30, 2002	Additions	Deletions	June 30, 2003
Furniture and equipment	$5,562,699	$ 39,396	$(12,879)	$5,589,216
Accumulated depreciation	(2,208,177)	(889,077)	10,948	(3,086,306)
Total	$3,354,522	$ (849,681)	$ (1,931)	$2,502,910

NOTE G - MULTI-STATE LOTTERY ASSOCIATION (MUSL)

Joint Venture Association - In November 1989, the Lottery joined the Multi-State Lottery Association. MUSL was created in September 1987 to operate a multi-state lottery game for the benefit of party lotteries. The Powerball game, Wild Card game and Hot Lotto game are presently the only games operated jointly by the members in which the Lottery participates. Each lottery participating in MUSL is represented on the Board of Directors.

Prize Reserve Fund Receivable/Payable - As a member of MUSL, the Lottery is required to contribute to various prize reserve funds maintained by MUSL. The contributions are to be used to fund unanticipated prize claims. All funds remitted and the related interest earnings will be returned to the Lottery upon leaving the association, less any portion of unanticipated prize claims, which may have been paid from the fund.

The Lottery contributes to the reserve fund through the set-aside for prizes. Payments made to the reserve fund are considered a portion of the prize expense associated with the on-line game.

During 1990, the MUSL Board created the unreserved accounts to record interest earned on the various prize reserve funds when the prize reserve fund balance is not below the predetermined ceiling amount. The amounts in the unreserved accounts may be used at the Board's discretion.

The long-term receivable balance of $1,742,643 and $2,100,876 at June 30, 2003 and 2002, respectively, represents the Lottery's share of the MUSL prize reserve fund that had a balance of $101,573,922 and $93,971,128 for 2003 and 2002, respectively. The long-term liability balance of $1,699,207 and $1,707,049 at June 30, 2003 and 2002, respectively, represents the Lottery's share of the total estimated prize liability.

Lotto*America Prizes and Investments - Prizes awarded to Lotto*America grand prize winners are paid in twenty annual installments funded by investments in United States Treasury zero coupon bonds. Bonds purchased on behalf of Montana source winners are held in trust by MUSL with the Montana State Lottery as beneficiary. As the bonds mature, the proceeds are forwarded to the Lottery and distributed to the grand prize winners on the anniversary date of each win.

At June 30, 2003 and 2002, MUSL held United States Government zero coupon bonds in trust for the Lottery winners with respective par values of $49,957,949 and $55,165,949 and respective market values of $42,958,311 and $43,163,160.

The Lottery has eight Lotto*America/Powerball/Tri-West winners. The combined total future prize payments owed is $51,042,588 and $55,165,000, at June 30, 2003 and 2002, respectively. Total annual payments due over each of the next five years is $5,461,088 annually and $23,737,148 thereafter. The present value of future prize payments approximates the current market value of the bonds held in trust for the Lottery winners.

Multi-State Lottery Association Financial Position - Information related to the Multi-State Lottery Association's audited financial statements is as follows:

	June 30, 2003	June 30, 2002
Total assets	$1,372,413,265	$1,294,979,136
Total liabilities	1,372,128,131	1,294,673,721
Total net assets	285,134	305,415
Total liabilities and net assets, unrestricted	$1,372,413,265	$1,294,979,136
Total revenues	$ 5,397,356	$ 6,604,958)
Total expenses	5,417,637	6,626,531
Decrease in unrestricted net assets	$ (20,281)	$ (21,573)

NOTE H - ESTIMATED PRIZE LIABILITY

The estimated prize liability represents the Lottery's estimate of prizes payable related to games in process at year-end based on the predetermined prize structure of each outstanding game.

NOTE I - OBLIGATION TO TRANSFER FUNDS

The Lottery is required to transfer its net revenue to the Montana State General Fund. This change was enacted through the passage of SB 83 by the 1995 Legislature and signed into law by Governor Racicot in April 1995. Transfer obligations outstanding at June 30, 2003 and 2002 were $1,811,272 and $1,591,454, respectively.

NOTE J - LONG-TERM LIABILITIES

Long-term liabilities consist of the following

	June 30,			
	Current	Long-Term	2003 Total	2002 Total
Prize liability Multi-State Lottery Association	$ -	$1,699,207	$1,699,207	$1,707,049
Accrued compensated absences	$ 107,343	77,995	185,338	168,815
Note payable - Norwest Investment, interest rate 5.12% for 5 years requiring quarterly payments of $286,394.30.	$1,109,836	-	1,109,836	$2,164,622
	$1,217,179	$1,777,202	$2,994,381	$4,040,486

Future scheduled principal maturities of the long-term note payable are as follows:

2004	$1,109,836
2005 and beyond	-0-
Total	$1,109,836

NOTE K - LEASES

The Lottery leases its office, administrative and warehouse facilities under a non-cancelable lease agreement that is effective March 2002 through February 2007. Rent expense under operating leases charged to operations was $86,228 and $80,600 for the years ended June 30, 2003 and 2002, respectively.

The Lottery also has an operating lease for office equipment, primarily the photocopier, with monthly payments of $428, which expires August 2005. Rental expenses for these leases consisted of $5,170 and $5,472 for the years ended June 30, 2003 and 2002, respectively.

Future minimum lease payments under operating leases that have remaining terms in excess of one year as of June 30, 2003 are:

Years ending June 30:	
2004	$93,922
2005	95,234
2006	91,849
2007	61,964
2008	-0-

NOTE L - EMPLOYEE BENEFIT PLANS

Pension Plan - The Lottery participates in the Public Employees Retirement System (PERS). PERS is a statewide mandatory cost-sharing multiple employer retirement plan which covers all employees. The plan is established under State law and is administered by the State of Montana. The plan provides disability and death benefits to plan members and beneficiaries as well as a choice of a defined benefit or a defined contribution retirement plan.

The plan issues a publicly available financial report that includes financial statements and required supplementary information. The report may be obtained from the following address: Public Employees Retirement System, Montana Public Employees Retirement Administration, P.O. Box 200131, 100 N. Park, Suite 220, Helena, MT 59620-0131, (406) 444-3154.

The contribution rate for the plan is required and determined by State law. The contribution rate for Fiscal Years 2003 and 2002, expressed as a percentage of covered payroll, was 6.9% for both years, for both the employer and the employees.

The amounts contributed to the plan during the years ended June 30, 2003 and 2002, were $147,159 and $137,503, respectively, and were equal to the required contributions for each year.

Deferred Compensation Plan - The Lottery's full-time regular employees are eligible to participate in the State of Montana's deferred compensation plan. The plan is administered by Benefits Corporation on behalf of Great West Life Insurance Company through a contract with the State of Montana. The amount of compensation deferred is not available to employees until termination, retirement, death, or unforeseen emergency. All amounts are deferred under the plan created under Internal Revenue Code Section 457 and Title 19, chapter 50, Montana Code Annotated (MCA). Assets of the deferred compensation plan are required to be held in trusts, custodial accounts or insurance company contracts for the exclusive benefit of participants and their beneficiaries.

NOTE M - RELATED PARTY TRANSACTIONS

During the ordinary course of business, other State agencies provide certain services and supplies to the Lottery. During 2003 and 2002, total payments to other State agencies were approximately $225,332 and $244,113, respectively.

NOTE N - COMMITMENTS AND CONTINGENCIES

Scratch Tickets - The Lottery has an agreement with Oberthur Gaming Technologies Corp. to print scratch game tickets. The contract expires August 8, 2008.

On-line Vendor - The Lottery is contracted with Scientific Games International to provide for the operation of an on-line gaming system through March 30, 2006. The estimated total contract price is approximately $24 million over the seven-year contract.

Advertising - The Lottery signed a contract with Banik & Associates to provide advertising services for $8,400 per month through December 2003.

Independent Observation of Drawings - The Lottery is committed to Galusha, Higgins and Galusha, PC, to observe Montana Cash and other special drawings. The term of the contract is for three years ending June 30, 2005. Compensation will not exceed $25,000 for the three year period.

Audit of Financial Statements - The Lottery is party to a contract with Galusha, Higgins and Galusha, PC, an independent accounting firm, to audit the Lottery's annual financial statements. The yearly contract was finalized on December 12, 2002, and is renewable annually for one additional year with the consent of all parties. Compensation for the years ended June 30, 2004 and 2003, will not exceed $12,000 and $12,000, respectively.

Prize Contingencies - Certain Big Spin prizes awarded are payable to the winners in annual installments spanning seventeen to twenty years with the first payment being made by the Lottery. The Lottery has entered into agreements with an insurance carrier under which purchased annuities will provide the required level of payments corresponding to the Lottery's obligation to these prize winners. Because it is the intent of the Lottery that the insurance carrier will make future installment payments directly to each prize winner, neither the present value of the annuities nor the present value of the future payments are reflected in the accompanying financial statements. The Lottery would be liable for such future payments in the gross amount of $950,588 and $1,203,676 at June 30, 2003 and 2002, respectively, if the insurance carrier defaulted on their payments.

NOTE O - RISK MANAGEMENT/PUBLIC ENTITY RISK POOL

The Lottery contributes to the Group Employee Comprehensive Medical and Dental Plan and the Property and Casualty Insurance plans of the State of Montana. Details of these plans can be found in the State of Montana Comprehensive Annual Financial Report.

Independent Auditors' Report
on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards

To the Commissioners
Montana State Lottery
Helena, Montana

We have audited the financial statements of Montana State Lottery (Lottery), an enterprise fund of the State of Montana, as of and for the year ended June 30, 2003, and have issued our report thereon dated October 8, 2003. We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the Lottery's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Lottery's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

This report is intended for the information of the Lottery's Commissioners, management and the Legislative Audit Committee and is not intended to be and should not be used by anyone other than those specified parties.

Galusha, Higgins & Galusha, PC

GALUSHA, HIGGINS AND GALUSHA, PC
Certified Public Accountants and Advisors
Helena, Montana
October 8, 2003

Montana Lottery
For the *fun* of it!

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